Demming
Financial Services Corp.

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2nd Quarter Newsletter

Spring 2015

Special Notes…

As a friendly reminder for your protection, it is now our policy that any requests for funds sent to us via email will be confirmed by phone.

Please be sure to forward us your 2014 year-end statements, W-2's and tax returns. You may have your tax preparer forward them to us via mail, fax or email at info@demmingfinancial.com.

Also, please be sure to check out our website at www.demmingfinancial.com!

Probable Maximum Loss – How to Control Investment Portfolio Losses

Article Courtesy of Ken Faulkenberry

In PORTFOLIO MANAGEMENT

Probable Maximum Loss

You can control investment losses by determining your probable maximum loss and choosing an asset allocation that is consistent with your investment decisions. How much of your investment portfolio can you afford to lose is one of the most critical questions you should ask yourself.

> *How much of your investment portfolio can you afford to lose is one of the most critical questions you should ask yourself.*

I believe most investors have been taught to invest too aggressively. We will examine why you shouldn't listen to the industry and media which is dominated by institutions that want you to buy and sell their products.

Portfolio Volatility and Managing Risk

Risk management analysis is an important part of any investing plan. Volatility doesn't seem to bother most investors during bull markets. This is one of the reasons investors are "lulled" into taking on additional risk as markets rise.

Studies show that investments with lower volatility tend to produce lower returns. This causes investors seeking higher rates of return to concentrate on high risk stocks. These more speculative stocks tend to lead the market up during rallies, but collapse in down markets.

The following chart, located on page 2, exhibits the challenge of making your investment back after you lose it. Notice that the more you lose, the amount you need to break even grows exponentially.

Why Is It SO Important to Avoid Investment Losses?

Portfolio volatility by itself greatly reduces your returns. This is because the money lost is capital

If You Lose:	Gain Required to Break Even:
5%	5
10%	11%
15%	18%
20%	25%
25%	33%
30%	43%
35%	54%
40%	67%
45%	82%
50%	100%
75%	300%
90%	900%

that is no longer available for investment. If you lose only 10%, you still have 90% of your capital available for investment. If you lose 50% you only have 50% of your capital available for investment, so a 100% gain is required to get back to break even.

When you experience large losses you have less to invest and then your portfolio is in a position that will probably take many years to back to break even. The reality of break even loss analysis makes losing 50% of your money intolerable! After losing 50%, IF the market gained 10% per year, and you were 100% invested, it would take 7 years (7 instead of 10 because of compounding) to get back to break even.

Controlling Investment Losses

Many investors invest too aggressively; they have been taught the outdated buy and hold strategy that causes them to sell in bear markets because they get to the point they can't stand the pain of a bear market anymore. They often sell at the point of maximum opportunity!

What is your risk management plan? Many in the financial industry will tell you to place stop loss orders on your individual stocks. But is it possible they recommend this because it creates more trading and therefore more fees or commissions? Why should you sell a stock after it falls? If the company's prospects haven't changed maybe you should buy more not sell at a loss.

Probable Maximum Loss – A Better Way!

An intelligent investor will determine what their probable maximum loss limit is for a one year period. Notice this is a "probable" loss not "possible" loss. Personally, I have decided that anything over a 20% loss becomes devastating to a portfolio. You may choose a different number. But I believe this approximates an ideal or optimum number for long term growth.

Calculating Your Maximum Loss Decision

Since 1926 there has only been 3 calendar years in which the S&P 500 total return was worse than a negative 30%. The only one greater that 40% was a negative 44% in 1931 in the great depression. There have been 5 drawdowns in the S&P 500 (from peak to trough regardless of time) of 30% or more since 1926; although the largest was a devastating 83% from Sept 1929 to June 1932.

1. Choose an assumed probable maximum loss for equities. After looking at the past I assume the probable maximum loss in the stock market is 40% in a year. You may choose a different number.
2. Choose the maximum loss you are willing to take to your portfolio. I have chosen 20% but you may choose a different number.
3. Divide your personal portfolio maximum loss by your assumed stock market probable maximum loss.

In my case this would calculate: .20 divided by .40 = .50 or 50%!

The result is my target equity asset allocation is 50%. This would be the average equity target for my portfolio when market valuations are average (or fair value).

2015 First Quarter Report: Stop Awaiting the Fed.

Dear Clients,

The first quarter of the New Year has brought us small positive returns in many of the U.S. and global indices, and more than the usual amount of anxiety along with them.

The Wilshire 5000--the broadest measure of U.S. stocks and bonds—was up 1.61% for the first three months of 2015, which is remarkable considering that the index lost .75% on the last day of the quarter.

The Wilshire U.S. Large Cap index gained 1.27% in the first three months of 2015. The widely-quoted S&P 500 index of large company stocks posted a gain of 0.44% in the first quarter of the year. The Wilshire U.S. Mid-Cap index gained 5.77% for the quarter.

Small company stocks, as measured by the Wilshire U.S. Small-Cap index, gave investors a 4.51% return during three months of the year. The technology-heavy Nasdaq Composite Index gained 3.48% for the quarter.

> *America is growing. Not rapidly, but slow growth might not be so terrible.*

Meanwhile, global markets are showing signs of life, which means returns finally comparable to the U.S. stock market. The broad-based EAFE index of companies in developed foreign economies gained 4.19% in dollar terms in the first quarter of the year, in part because Far Eastern stocks were up 8.27%. In aggregate, European stocks gained 5.15%, although they are still down more than 8% over the past 12 months. Emerging markets stocks of less developed countries, as represented by the EAFE EM index, fared less well, gaining 1.91% for the quarter.

Looking over the other investment categories, real estate investments, as measured by the Wilshire U.S. REIT index, was up 4.67% for the first quarter, despite falling 0.87% on the final day. Commodities, as measured by the S&P GSCI index, continued their losing ways, dropping 8.22% of their value in the first quarter, largely because of continuing drops in oil prices.

If you were watching the markets day to day, you experienced a mild roller coaster, what trading professionals refer to as a sideways market. One day it was up, the next down, each day (or week) seeming to erase the gains or losses of the previous ones. The best explanation for this phenomenon is that investors are still looking over their shoulders at interest rates, waiting for bond yields to jump higher, making bonds more competitive with stocks and triggering an outflow from the stock market that could (so the reasoning goes) cause a bear market in U.S. equities.

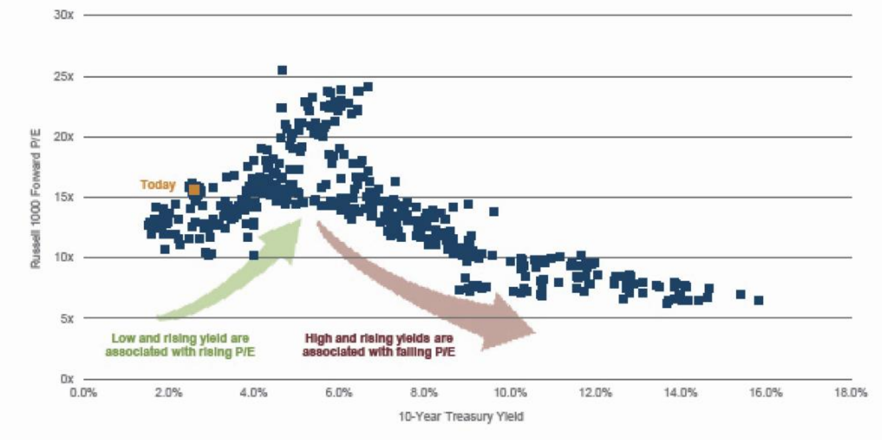
However, investors have been waiting for this shoe to drop for the better part of three years, and meanwhile, interest rates have drifted decidedly lower in the first quarter. The Bloomberg U.S. Corporate Bond Index now has an effective yield of 2.93%. 30-year Treasuries are yielding 2.48%, roughly 0.3% lower than in December, and 10-year Treasuries currently yield 1.87%, down from 2.17% at the beginning of the year. At the low end, you need a microscope to see the yield on 3-month T-bills, at 0.02%; 6-month bills are only slightly more generous, at 0.10%.

This interest rate watch has created a peculiar dynamic where up is down and down is up in terms of how traders and stock market gamblers look at the future. The generally positive economic news is greeted with dismay (The Fed will notice and start raising rates sooner rather than later! Boo!) and any bad news sends the stock market back up again into mild euphoria (The Fed might hold off another quarter! Yay!).

There are several obvious problems with this. First, probably least important, the Fed's future actions are inscrutable. You will hear knowledgeable Fed-watchers say that the Fed will take action as early as June or as late as next year, and none of them really know.

Second, small incremental rises in interest rates are not closely associated with bear markets, as everybody seems to assume. Figure 1 is a little hard to interpret, but each blue square shows the price/earnings ratio for the U.S. stock market as a whole after interest rates have risen to particular

Figure 1: Treasury rates (horizontal axis) associated with Russell 1000 PE ratios

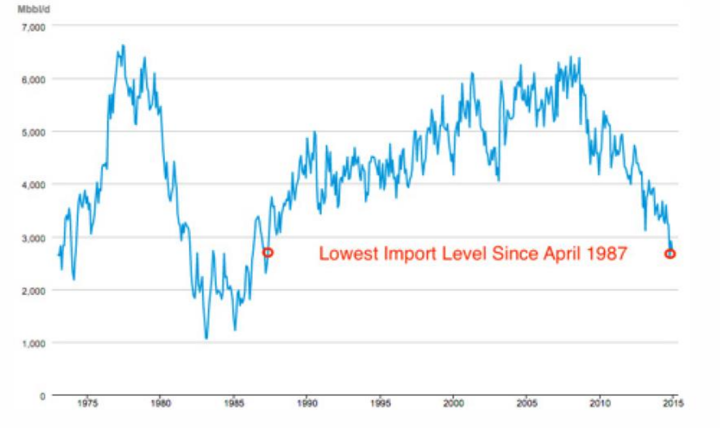


levels, almost all of them higher than today. What you see is that when rates have gone up in the past, the price people will pay for stocks has also gone up. Why? For exactly the reason you think: rising rates are a sign of a healthy economy, which is precisely why the Federal Reserve Board would decide that stimulus is no longer necessary. Companies—and their stocks—tend to thrive in healthy economies.

The chart also shows that rates can get too high for the health of stocks—the cutoff point seems to be up around 5.5% to 6%. But incremental quarter-point rises are not going to take the U.S. economy into that territory for a long time.

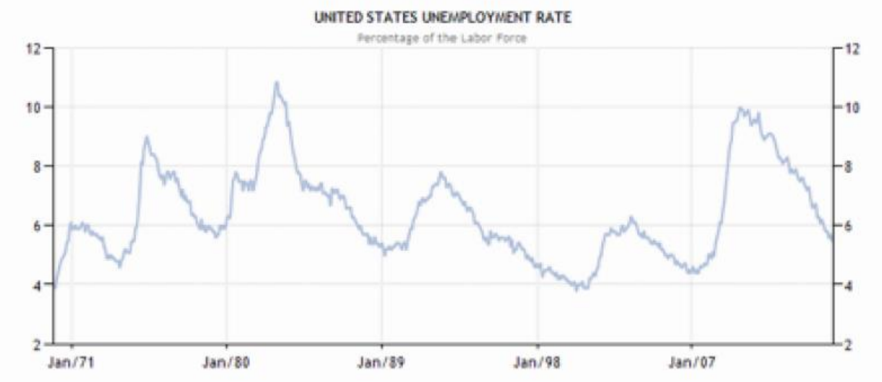
Finally, we should all welcome the Fed pullback, not fear it. A lot of the uncertainty among traders and even long-term investors is coming from anxiety over how this experiment is going to end. The U.S. Central bank has directly intervened in the markets and in the economy, and is still doing so. When that ends, normal market forces will take over, and we'll all have a better handle on what "normal" means in this economic era. Is there great demand for credit to fuel growth? What would rational investors pay for Treasury and corporate bonds if they weren't bidding against an 800-pound gorilla? Would retirees prefer an absolutely certain 4.5% return on 30-year Treasury bonds or the less certain (but historically higher) returns they can get from the stock market? These are questions that all of us would like to know the answer to, and we won't until all the QE interventions have ended.

Figure 2: Number of millions of barrels of oil imported from OPEC since 1970.



What DO we know? Figure 2 shows that the U.S. economy is less dependent on foreign oil than at any time since 1987, and the trend is moving toward complete independence. Oil—and energy generally—is cheaper now than it has been in several decades, which makes our lives, and the production of goods and services, less expensive.

Figure 3: U.S. unemployment rate since 1970.



Meanwhile, more Americans are working. Figure 3 shows that the U.S. unemployment rate—at 5.5%—is trending dramatically lower, and is now reaching levels that are actually below the long-term norms. Unemployment today is lower than the rate for much of the booming '90s, and is approaching the lows of the early 1970s.

And real GDP—the broadest measure of economic activity in the United States—increased 2.4% last year, after rising 2.2% the previous year. America is growing. Not rapidly, but slow growth might not be so terrible. Rapid economic growth has, in the past, often preceded economic recessions, where excesses had to be corrected. Slow, steady growth may be boring, but it's certainly not bad news for the economy or the markets. For fun, look at Figure 4, which shows, in a creative way, the size of the U.S. economy compared with the rest of the world. Each U.S. state is labeled with an entire country whose total economic output is roughly equal to that state's. The point: the U.S. is still a colossus that stands across the global economy.

Figure 4: What foreign country matches each U.S. State's total GDP?

Patience and prudent temperament will be key in the quarters ahead. As markets continue recovering, our margins of safety narrow while prices rise. We have to temper our expectations while recognizing there is plenty of positives to reinforce the trends. People who listened to the alarmists lost out on solid returns. You filter out the good news at your peril.

"SIR, THERE'S AN IRVING R. SCHWARTZ TO SEE YOU."

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Sources:

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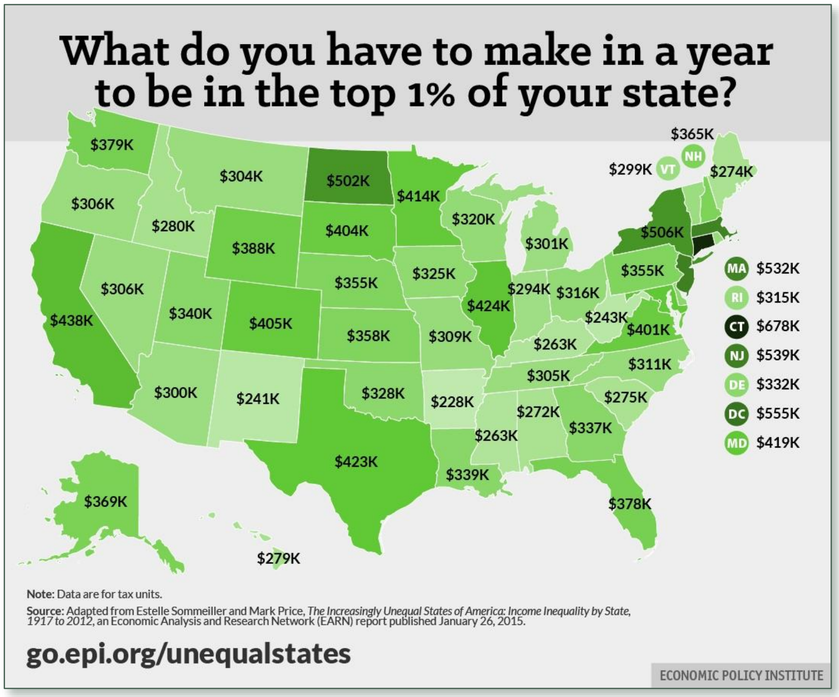

Note: Data are for tax units.

Source: Adapted from Estelle Sommeiller and Mark Price, *The Increasingly Unequal States of America: Income Inequality by State, 1917 to 2012*, an Economic Analysis and Research Network (EARN) report published January 26, 2015.

go.epi.org/unequalstates

As a friendly reminder, please be sure to forward us your 2014 tax returns as they are completed.